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E.O. 12958: N/A
TAGS: ECON EFIN EINV HK
SUBJECT: BLOWING A PROPERTY BUBBLE IN HONG KONG

REF: HONG KONG 191

¶1. (U) Summary: After dipping to levels not seen since the 1980s, Hong Kong's property market has rebounded surprisingly strongly over the past three months. Transaction volumes have returned to pre-financial crisis levels and residential property prices, while still down from their 2008 peak, have increased 25 percent from recent lows. New mortgage interest rates have fallen to below 2.5 percent (less than half the 5 percent "prime rate" for commercial lending). Speculators are starting to show more interest, but the large majority of buyers appear to be local residents trading up as properties become more affordable. Commercial rents continue to drop, but sale prices for prime commercial real estate are increasing, suggesting that property managers are optimistic about Hong Kong's longer-term prospects. Property analysts are puzzled by the good news, coming at a time when Hong Kong economic fundamentals are still weak, and are predicting another slide in prices and transaction volumes later this year. End summary.

¶2. (SBU) Comment: Property analysts have touted property development company stocks, property transactions and prices as leading indicators for Hong Kong,s economic performance. We've seen a significant increase in these figures since March, but without signs of corresponding improvements in Hong Kong,s real economy. This suggests the run up in the stock and property markets in Hong Kong is an asset bubble fueled by the rapidly expanding money supply. The Hong Kong Monetary Authority (HKMA) has injected billions of dollars into the banking system since September 2008 to grease the frozen interbank market. That monetary expansion has been compounded by roughly US$27 billion in foreign currency inflows over the past several months effectively doubling Hong Kong's Monetary Base. Local asset prices are likely to remain high until a reversal of that process forces Hong Kong stock and property markets down. End Comment.

Hong Kong Property Bouncing Back

¶3. (U) Property transactions in Hong Kong have surged since March 2009, returning to pre-financial crisis levels far more quickly than most local analysts expected. Concerns about the state of the U.S. banking system in mid-2008 began to hit Hong Kong property transactions in August and by November, the local market was almost stagnant, with transactions falling to levels not seen since the 1980s (reftel). After several months of moribund volumes and falling prices, Hong Kong buyers began testing the market again in March 2009. Transactions increased steadily from February to May, with sales up 160 percent over those three months. May 2009 transactions were up 28 percent from same period in 2008.

¶4. (U) After falling by as much as 40 percent between

February and December 2008, property prices have also begun to increase again, according to Centaline Property Agency statistics. The price recovery extends to all of Hong Kong's major regions, with property values increasing by an average of approximately 15 percent from their December 2008 low. Prices for luxury properties on Hong Kong Island fell furthest, but have also recovered fastest, with units now priced at December 2007 levels. Centaline Vice Chairman Sherman Lai said that many of the luxury property buyers are investors, not speculators. The return on luxury rentals in Hong Kong is less than 3 percent, he said, but with banks paying just 0.01 percent on deposits that is much better than most other non-equity investments at the moment. Many of these investors are simply looking for a small return along with a safe place to keep their cash.

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Locals, Not Speculators, Driving the Market

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¶5. (U) Professional Properties and Services (PPS) Chairman Nicholas Brooke agreed that speculators are not driving the recent price and transaction increases. Market-wide, he estimated that only 20 percent of buyers are investors, and noted that 80 percent of transactions since March 2009 have been "mass market" properties, i.e., those smaller than 1500 square feet. Many recent buyers are Hong Kong residents, attracted by relatively low prices and falling mortgage rates, seeking to "move up" the housing ladder. These buyers were shut out of the housing market last year when prices soared, but continue to believe in Hong Kong's long-term economic prospects. Real estate is still an attractive and

tangible asset and some undoubtedly see the current dip as their opportunity to buy low before they are priced out of the market once again, said Brooke. Falling mortgage interest rates are clearly enticing some buyers. Mortgage applications have surged since March, with new approvals growing by 30 percent each month through May. In February, the majority of mortgages carried interest rates over 3 percent. By May, a sizeable majority of new mortgages offered adjustable interest rates below 2.5 percent.

¶6. (U) Commercial property transactions and prices lag residential sales, but are also increasing after falling fifty percent from last year, said Lim Advisors Director Peter Churchouse. Prices for premium office space in the Central business district have returned to July 2008 levels, though still well below peak prices. This despite increasing office vacancies and falling rents. Investors continue to see strong long-term prospects for commercial property in established areas, he said, and will continue to buy despite short-term losses. Brooke predicted that residential rents, particularly in the luxury sector, would also continue to fall as the school year ends and expatriates who have been laid off or had their compensation reduced depart Hong Kong.

¶7. (U) Hong Kong property development company shares are benefiting from Hong Kong's property rebound. Since the beginning of March 2009, Cheung Kong Holdings share price has increased 66 percent, Sun Hung Kai Properties is up 79 percent, Henderson Land shares are up 88 percent, Hang Lung Properties shares have risen 91 percent and New World Development shares are now up 132 percent. Property and financial services shares have driven the Hong Kong Stock Exchange benchmark Hang Seng Index up 64 percent since March.

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Loose Money Fueling Property Boom

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¶8. (SBU) Our interlocutors agreed that property development company shares, property prices and transaction volumes have been valuable indicators of Hong Kong economic prospects in the past, but were puzzled by the recent flurry of activity

in spite of a steady stream of bad economic news. Hong Kong's GDP in the first quarter of 2009 fell by 7.8 percent (year on year real terms). Consumption fell 5.5 percent and investment was down 12.6 percent over the same period. Exports and imports dropped over 15 percent in Q1 and continued at that level through April. Unemployment is now 5.3 percent, low by some standards but a level not seen since in Hong Kong for several years and almost double the rate just a year ago. Lai argued that the increasing activity in the property market reflects a reallocation of assets as Hong Kong investors start looking for higher, but still relatively safe, returns. Brooke and Churchouse agreed that the positive market performance was driven by factors other than Hong Kong's economic fundamentals and predicted that the poor economic climate will soon force prices and transactions down again.

¶9. (SBU) The property market and the Hang Seng Index (up 64 percent since March 9) have risen in tandem, perhaps providing a clue to the cause of their rapid ascent. Since September 2008, the HKMA has more than doubled the Monetary Base from US$42.2 billion to US$91 billion. The Monetary Base is comprised of Certificates of Indebtedness, notes and coins in circulation, the Aggregate Balance of the Banking System (the sum of bank clearing and reserve accounts), and outstanding Exchange Fund bills. In response to extremely tight interbank liquidity in September 2008, the HKMA in October began issuing additional Exchange Fund paper to help banks manage their liquidity needs. Over the past nine months, the stock of outstanding Exchange Fund paper has increased from US$19 billion to US$37.7 billion. The Aggregate Balance increased from just US$606 million to US$28.1 billion as foreign currency inflows have flooded Hong Kong, drawn by Hong Kong's easy convertibility and the HKMA's 100 percent bank deposit guarantee. With so much money in circulation, inflated asset prices are a predictable response.
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